No. 5710

In the United States Circuit Court of Appeals for the Ninth Circuit

WALVILLE LUMBER COMPANY, A CORPORATION, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

ON PETITION TO REVIEW AN ORDER OF THE UNITED STATES BOARD OF TAX APPEALS

BRIEF FOR THE RESPONDENT

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CITATIONS

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PREVIOUS OPINION

The only previous opinion in this case is that of the United States Board of Tax Appeals (R. 32–35), which is reported in 12 B. T. A. 152.

JURISDICTION

The appeal in the above-entitled cause involves income and profits taxes for the year 1919 in the amount of $7,514.86, and is taken from a decision (order of redetermination) by the Board of Tax Appeals entered May 31, 1928. (R. 36.) The case is brought to this court by petition for review filed

November 23, 1928 (R. 44), pursuant to the provisions of the Revenue Act of 1926, c. 27, Sections 1001, 1002, 1003, 44 Stat. 9, 109, 110.

QUESTION PRESENTED

In the year 1908 the taxpayer corporation was organized, and with its stock purchased all of the assets of the Walworty & Neville Manufacturing Company, together with 4,400 shares of the stock of the manufacturing company, the latter costing (March 1, 1913, value) $225,967.28, which gave taxpayer control of the manufacturing company. In 1919 taxpayer reduced its capital stock from 10,000 shares to 5,000 shares. At the time of this reorganization the manufacturing company owned 5,541 shares, or 55.41%, of the stock of taxpayer, and, in accordance with the said reorganization of taxpayer, the manufacturing company became entitled to receive 2,770½ shares of taxpayer's stock. In order to effect a liquidation of the manufacturing company, in 1919 taxpayer, instead of issuing to the manufacturing company the stock of taxpayer which the manufacturing company owned and was entitled to receive, pursuant to taxpayer's reorganization, issued all of said stock to stockholders of the manufacturing company except 756 shares, which remained unissued and which had a value of $107,197.53.

The sole question involved is whether taxpayer is entitled to claim as a loss for the year 1919 the difference between the cost to it of the stock of the

manufacturing company which it purchased in 1908 and the value of the 756 shares of its stock which remained unissued at the time of the dissolution of the manufacturing company.

STATUTE AND REGULATIONS INVOLVED

The pertinent provisions of the Revenue Act of 1918, c. 18, 40 Stat. 1057, are as follows:

> SEC. 234. (a) That in computing the net income of a corporation subject to the tax imposed by section 230 there shall be allowed as deductions:
>
> * * * * *
>
> (4) Losses sustained during the taxable year and not compensated for by insurance or otherwise;
>
> SEC. 201. * * *
>
> (c) A dividend paid in stock of the corporation shall be considered income to the amount of the earnings or profits distributed. Amounts distributed in the liquidation of a corporation shall be treated as payments in exchange for stock or shares, and any gain or profit realized thereby shall be taxed to the distributee as other gains or profits.
>
> SEC. 202. (a) That for the purpose of ascertaining the gain derived or loss sustained from the sale or other disposition of property—real, personal, or mixed—the basis shall be—
>
> (1) In the case of property acquired before March 1, 1913, the fair market price or value of such property as of that date; and

(2) In the case of property acquired on or after that date, the cost thereof; or the inventory value, if the inventory is made in accordance with section 203.

(b) When property is exchanged for other property, the property received in exchange shall for the purpose of determining gain or loss be treated as the equivalent of cash to the amount of its fair market value, if any; but when in connection with the reorganization, merger, or consolidation of a corporation a person receives in place of stock or securities owned by him new stock or securities of no greater aggregate par or face value, no gain or loss shall be deemed to occur from the exchange, and the new stock or securities received shall be treated as taking the place of the stock, securities, or property exchanged.

When in the case of any such reorganization, merger, or consolidation the aggregate par or face value of the new stock or securities received is in excess of the aggregate par or face value of the stock or securities exchanged, a like amount in par or face value of the new stock or securities received shall be treated as taking the place of the stock or securities exchanged, and the amount of the excess in par or face value shall be treated as a gain to the extent that the fair market value of the new stock or securities is greater than the cost (or if acquired prior to March 1, 1913, the fair market value as of that date) of the stock or securities exchanged.

Treasury Regulations 45 (1920 Edition):

Art. 862. *Purchase of stock.*—Where a corporation either directly or indirectly, as for example through a trustee, has prior to the taxable year bought its own stock, either for the purpose of retirement or of holding it in the treasury or for other purposes, the entire cost of such stock must be deducted from the aggregate invested capital as of the beginning of the taxable year, if such deduction has not already been made. Where such stock is purchased during the taxable year a deduction from the invested capital as of the beginning of the taxable year and effective from the date of such purchase is required only to the extent that such stock has not been purchased out of the undivided profits of the taxable year. See article 857. The full amount derived in cash or its equivalent from the resale of such stock may be included in the invested capital from the date of such resale, unless such stock had been purchased out of earnings of the taxable year. See article 542.

Art. 1548. *Distribution in liquidation.*—So-called liquidation or dissolution dividends are not dividends within the meaning of the statute, and amounts so distributed, whether or not including any surplus earned since February, 28, 1913, are to be regarded as payments for the stock of the dissolved corporation. Any excess so received over the cost of his stock to the stockholder, or over its fair market value as of March 1, 1913, if ac-

quired prior thereto, is a taxable profit. A distribution in liquidation of the assets and business of a corporation, which is a return to the stockholder of the value of his stock upon a surrender of his interest in the corporation, is distinguishable from a dividend paid by a going corporation out of current earnings or accumulated surplus when declared by the directors in their discretion, which is in the nature of a recurrent return upon the stock.

STATEMENT OF FACTS

The petitioner was incorporated in 1908 under the laws of the State of Washington, with authorized capital stock of $1,000,000, divided into 10,000 shares of the par value of $100 each. In the same year it acquired from the Walworth & Neville Manufacturing Company, a Michigan corporation, certain timberlands, cut-over lands, sawmill, cross-arm factory, machinery, and equipment, and 4,400 shares of the stock of the Walworth & Neville Manufacturing Company, and issued therefor its entire authorized capital stock to persons not disclosed by the record. The value of this property at date of acquisition by the petitioner was $1,170,000. (R. 29–30.)

The 4,400 shares of stock acquired from the Walworth & Neville Manufacturing Company, as above set forth, and owned by the petitioner at March 1, 1913, had a fair market value of $225,967.28 on that date. In the taxable year the Walworth &

Neville Manufacturing Company owned 5,541 shares of the stock of the petitioner. (R. 30.)

In 1919 the petitioner reduced its capital stock without consideration to 2,500 shares of common stock and 2,500 shares of preferred stock, all of the par value of $100 each. This procedure reduced the 5,541 shares of the petitioner's stock then owned by the Walworth & Neville Manufacturing Company to 1,385¼ shares of common and 1,385¼ shares of preferred. In the distribution of its reduced stock the petitioner issued 1,385¼ shares of preferred to certain owners of the preferred stock of the Walworth & Neville Manufacturing Company, 629¼ shares of common to other stockholders of such company, 1,114¾ shares of preferred and 1,114¾ shares of common to its other shareholders, and retained unissued 756 shares of common stock. (R. 30–31.)

At the request of the Walworth & Neville Manufacturing Company, the preferred stock and the common stock which it had coming to it from petitioner were issued directly to the stockholders of the Walworth & Neville Manufacturing Company, In addition thereto, the 756 shares of common stock which were never issued by petitioner represented stock which petitioner would have received if it had issued to the Walworth & Neville Manufacturing Company all of the stock that was due that company when a liquidation of that company had taken place. (R. 7, 66.)

Upon the completion of the reorganization of the petitioner the Walworth & Neville Manufacturing Company had no assets, except its interest in the stock of the petitioner, and was dissolved with its outstanding stock of the par value of $440,000 owned by the petitioner. It was also in debt to its own preferred stockholders in amounts not disclosed by the record.

In its income and profits tax return for the year 1919 the petitioner estimated the value at March 1, 1913, of its 4,400 shares of the stock of the Walworth & Neville Manufacturing Company at $150,-000, and deducted as a loss sustained in the taxable year the difference between such value and the par value of its 756 shares of unissued stock in the amount of $74,400. The respondent disallowed the deduction so claimed and determined the deficiency here in controversy. The parties agree that the stock of the Walworth & Neville Manufacturing Company owned by the petitioner had a fair market value of $225,967.28 at March 1, 1913, and that the unissued stock of the petitioner in the taxable year had a fair market value of $107,197.53, and that the Walworth & Neville Manufacturing Company owned, 5,541 shares of the common stock of the petitioner just prior to the reorganization thereof. (R. 31.)

The stock of the Walworth & Neville Manufacturing Company consisted of 8,000 shares of common and 1,000 shares of preferred. At the date of

the reorganization of the transactions involved in this proceeding the petitioner owned 44/80th of the common stock of the Walworth & Neville Manufacturing Company and the Walworth & Neville Manufacturing Company owned 55.41 per cent of the stock of the petitioner. (R. 31–32.)

SUMMARY OF ARGUMENT

The facts in the case show that petitioner, through a mutual arrangement entered into with the Walworth & Neville Manufacturing Company, voluntarily acquiesced in the surrender of assets which it was entitled to receive upon the dissolution of the manufacturing company in the year 1919. Under such circumstances petitioner can not claim a deductible loss for the year 1919 of the difference between the cost of its investment in the manufacturing company and the value of the assets which it actually received from the manufacturing company upon its liquidation, since, if the petitioner had received the assets to which it was entitled, no loss would have occurred.

Furthermore, the effect of the transaction involved was the purchase by the petitioner of its own stock, from which no deductible loss could arise. Article 862, Treasury Regulations 45; *Appeal of Simmons & Hammond Manufacturing Company*, 1 B. T. A. 803.

ARGUMENT

I

The facts as established by the record support the decision of the Board of Tax Appeals and do not support the theory advanced by petitioner

Petitioner's investment in the stock of the Walworth & Neville Manufacturing Company cost (March 1, 1913, value), $225,967.28. This investment was extinguished in the year 1919 upon the dissolution of the manufacturing company and the petitioner claims a loss of the difference between the cost of the stock of the manufacturing company and the value of the assets which it received from the manufacturing company upon its dissolution.

Petitioner claims that the only assets which it was entitled to receive, and did receive from the manufacturing company on its liquidation, was 756 shares of its own stock, of the value of $107,197.53, and that it thus realized a deductible loss of $118,769.75 for the year 1919.

The Board of Tax Appeals decided that had petioner received the assets which it was entitled to receive upon the dissolution of the manufacturing company and which the petitioner could receive, and would have received had it not voluntarily agreed to accept less, no loss would have been sustained by it.

It seems clear that if in fact petitioner was entitled to receive more of the assets of the manufac-

turing company than it actually received under the circumstances of the instant case, it can not predicate a loss upon what it actually did receive. If petitioner voluntarily acquiesced in accepting a lesser amount of the assets of the manufacturing company than it was entitled to receive, and which it could undoubtedly have received upon the liquidation of the manufacturing company had it so desired and insisted, it can not claim a loss. As pointed out by the Board of Tax Appeals in its opinion, the relationship existing between the two corporations was such that the dissolution of the manufacturing company was necessarily accomplished for the mutual benefit of both corporations and with the consent and knowledge of the stockholders of each. This is apparent from the fact that the stockholders of the manufacturing company received directly from petitioner stock which the Board of Tax Appeals decided belonged to the manufacturing company rather than to such stockholders. The explanation of a transaction thus handled might lie in the fact that the stockholders of petitioner and the stockholders of the manufacturing company were identical or substantially so, but the record is silent on this question. In any event, petitioner apparently concedes that the Board's position is sound provided it is supported by the evidence in the case, but contends that the record does not support such position. On the contrary, petitioner asserts that the record establishes

conclusively that the 756 shares of unissued stock represent the entire interest of petitioner in the assets of the manufacturing company. The decision of the case in the first instance, therefore, rests upon the question whether the proof contained in the record supports the Board's contention or the theory of the petitioner.

Petitioner on its part has singled out a portion of the testimony of J. H. Neville (Petitioner's Brief, p. 21), which it is claimed established conclusively that the 756 shares of stock were all that the petitioner was entitled to receive upon the dissolution of the manufacturing company had the regular corporate formalities been carried out. Its whole case rests upon the effect to be given this testimony. Aside from the fact that neither the Board nor this court could be bound by the testimony of a witness as to what the legal rights of a stockholder are, it seems quite clear that the true meaning of the testimony of Mr. Neville, when considered as a whole, and in connection with the allegations contained in the petition filed before the Board which were admitted by the Government, has been misunderstood by petitioner.

Preceding the portion of the testimony by Mr. Neville relied upon by petitioner, we find the following (R. 66):

> The Walville Lumber Company issued all of its preferred stock and all of its common stock except 756 shares, which remained un-

> issued. Thereafter, the Walworth & Neville Manufacturing Company was dissolved, having no assets on hand. At the request of the Walworth & Neville Manufacturing Company the preferred stock and the common stock *which it had coming to it from the Walville Lumber Company* was issued directly to the stockholders of the Walworth & Neville Manufacturing Company. (Italics ours.)

In this testimony the witness is explaining the disposition of the stock of the petitioner which was issued. It is clearly stated that the stock which petitioner issued to the stockholders of the manufacturing company was stock which the manufacturing company had coming to it from petitioner. The testimony relied upon by petitioner relates to the unissued portion of its stock and clearly what Mr. Neville had in mind was that the 756 shares were not what petitioner would have been entitled to as a liquidating dividend in the first instance, but what would have been due it after a greater part of its share in the assets in the manufacturing company had been issued directly to stockholders of that company.

The correctness of this view is clearly demonstrated by the allegations of taxpayer's petition (R. 7), which are admitted by the respondent's answer (R. 26), and which read as follows:

> 5. Prior to the reduction of the capital stock of the petitioner, the Walworth &

Neville Manufacturing Company was also the owner or holder of 5,541 shares, par value $554,100.00, of the petitioner's capital stock, scaled down to 2,770½ shares consisting of 1,365¼ shares of common and 1,385¼ shares of preferred stock.

6. No certificate or certificates evidencing the reduced shares of stock of the petitioner were ever issued to the Walworth & Neville Manufacturing Company representing the said 2,770½ shares, or any other number; instead, certificates for 1,385¼ shares of preferred stock and 629¼ shares of common stock were issued directly to certain stockholders of the Walworth & Neville Manufacturing Company.

7. The balance of the said 1,385¼ shares of the common stock of the petitioner referred to under (6) above, or 756 shares, were never issued.

These admitted facts show that if the manufacturing company had received the stock which it was entitled to receive from petitioner, it would have received 1,385¼ shares of common stock and an equal number of preferred stock. As pointed out by the Board in its opinion (R. 34), a distribution by the manufacturing company to its stockholders in proportion to their respective stockholdings would have given petitioner, who owned 4,400 shares of the 9,000 outstanding shares of the manufacturing company, title to 1,354¼ shares of its stock instead of to 756 shares, which it construc-

tively received. This conclusion is a matter of mathematical calculation and clearly shows that the portion of the testimony of Mr. Neville relied on by petitioner has either been misunderstood or is in error.

The Board of Tax Appeals was, therefore, clearly right in its view of the case, and this would have been true regardless of Mr. Neville's testimony, because the stock interest of petitioner would have shown, as a matter of law, that petitioner would have been entitled to more than 756 shares had a liquidation of the manufacturing company actually occurred in regular manner.

II

The effect of the transaction was a purchase back by petitioner of its own stock from which no deductible loss could arise

While we believe the grounds on which the Board of Tax Appeals bases its decision are sound and should dispose of the case, it also seems apparent that the transaction involved is not one from which a deductible loss can arise. This is the theory on which the Commissioner's assessment was originally made.

In effect, petitioner, who, at the request of the manufacturing company, engineered the liquidation of that company (R. 35), purchased back its

own stock which the manufacturing company owned and paid therefor the 4,400 shares of stock of the manufacturing company which petitioner owned. On this theory, the amount or value of the stock which petitioner received upon parting with its stock in the manufacturing company is unimportant, since a corporation can not realize a deductible loss upon the purchase of its own stock. This principle is recognized by Article 862 of Treasury Regulations 45, *supra,* which provides that where a corporation purchases its own stock, either for the purpose of retirement or of holding it in the treasury, or for other purposes, the entire cost of such stock must be deducted from the aggregate invested capital as of the beginning of the taxable year if such a deduction has not already been made. This regulation has been consistently followed by the Commissioner of Internal Revenue for many years in his administration of the taxing statutes and has been approved by the Board of Tax Appeals in several decisions. See *Appeal of Simmons & Hammond Manufacturing Company,* 1 B. T. A. 803.

Even if there were something other than a purchase of stock and the transaction be considered as having been carried out in accordance with petitioner's theory, with regular corporate formalities, the transaction does not disclose a real loss. On this theory there would have been, first, an issuance to

the Walworth & Neville Manufacturing Company, as a stockholder, of its proportionate share of petitioner's reduced stock; next, a distribution in liquidation to petitioner of 756 shares of its own stock as its stockholders' interest in the assets of the manufacturing company. When the stock was issued to the manufacturing company it could have the effect only of decreasing the value per share of petitioner's outstanding stock. When the 756 shares were returned, the per share value of outstanding stock was increased, but no other real effect could have been produced because the only assets the manufacturing company had were the shares of petitioner's stock (R. 31–32), the value of which depended upon the value of petitioner's assets. Not having parted with any of these assets, petitioner could have sustained no real loss, and the decisions of the Board of Tax Appeals cited in petitioner's brief are not in point. On the contrary, upon principle, the case would be essentially similar to the case of *Simmons & Hammond Manufacturing Company, supra,* where it was held that a corporation sustains neither taxable gain nor deductible loss through the purchase and sale of its own stock.

CONCLUSION

The decision of the Board of Tax Appeals is amply supported by the facts in the case and should be affirmed. It is further submitted that the trans-

action involved is not one out of which a deductible loss could arise.

Respectfully,

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